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# The Province of Alberta

IN THE MATTER OF "THE NATURAL GAS UTILITIES ACT"

—and—

IN THE MATTER OF an Enquiry into Scheme to be adopted for Gathering, Processing and Transmission of Natural Gas in Turner Valley

G. M. BLACKSTOCK, Esq., K.C., *Chairman*

Dr. E. H. BOOMER, F.C.I.C., *Commissioner*

*Session:*

CALGARY, Alberta November 6th, 1945

VOLUME 50

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# I N D E X

VOLUME 50

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9.30 a.m.

VOLUME 50

9.30 A.M.Session, - 3856 -
November 6th, 1945.

Robert W. Hamilton,
Cross-Exam. by Mr. Chambers.

ROBERT WINSLOW HAMILTON,

having been recalled, cross-examination by Mr. Chambers continued:

MR. STEER: Mr. Chairman, might I ask before Mr. Chambers starts, is it intended to go into the question of competitive fuels tomorrow?

THE CHAIRMAN: I do not know what Mr. McDonald arranged, Mr. Steer.

MR. STEER: If that question is to be gone into I am obliged to arrange for the attendance of a witness.

THE CHAIRMAN: I do not think, wait a minute, Mr. Denton is to give evidence on that?

MR. STEER: Yes.

WITNESS: Mr. Denton is the name I heard Mr. McDonald mention in connection with tomorrow.

THE CHAIRMAN: Is your witness in town, Mr. Steer?

MR. STEER: No sir, I have to get him from Edmonton.

THE CHAIRMAN: Mr. McDonald is not here just at the moment but we will find out as soon as Mr. McDonald comes in.

MR. CHAMBERS: Shall I proceed now?

THE CHAIRMAN: Yes.

Q MR. CHAMBERS: Mr. Hamilton, when we rose yesterday I had put to you the question as to why Royalite or Madison should not be placed in the same position as the hypothetical packing company which I had put to you; have you thought that matter over?

A Yes, I think that if it could be clearly demonstrated that

theRoyalite Oil Company could sell that plant for a specific figure, that that would be a very useful guide to the Board in determining value for present purposes. On the other hand we must not overlook the fact that this is not the case of a sale but a case of trying to establish a value which should be returned to the Company in the form of annual depreciation charges over a period of time when price levels have fluctuated; further than that, of course, it must be borne in mind that the price levels had changed from time to time and that very circumstance tends to place capital of every kind at a hazard irrespective of the form in which the investment is found.

If again you were to give cognizance to the higher price levels at this juncture, I think it would be necessary to concede that you would have to change the rate base every year for price levels.

Q Now, Mr. Hamilton, I would like to make this clear, - I am not suggesting that every time there is a change in price levels there should be a rate hearing throughout the course of the operations of this company in the future, that there should be a hearing on reproduction costs, but the idea I had in mind is this, that this property is now being brought under regulation for the first time, in other words, the rules are being changed and from now on any party putting money into a proposition of this kind knows what those rules are, and they have been told of them, but what I am suggesting is that when you bring a property under regulation for the first time, that to have equity between the party who has put his money in over the years in the past and the consumer for the future, that present day values, reproduction costs now perhaps with depreciation, should be adopted and as one of the reasons or illustrations of why that should be done I put to you

the packing house situation.

A As I recall the fundamental point in the packing house case to which you refer, was they were able to sell the plant for a certain sum of money.

Q Yes?

A And I said this morning that if Royalite could demonstrate that they could sell that plant for a given figure, that that would be very useful information to the Board for the present purposes. It might even be the deciding factor. You might recall with regard to the separate plants that I place more reliance on the apparent market value of the equipment than upon its original costs.

Q Well I suggest to you this, Mr. Hamilton, and you agreed with me, that the packing house could probably have sold its property for more than it had spent on it throughout the years from 1921 to 1943?

A That is right.

Q Now is it not reasonable to assume that a party in the gas business would not be able to sell, - I mean rather would be able to sell for more than the actual cost throughout the years?

A It is something that is possible, I suppose, that is a possible assumption.

Q It is not a very violent assumption, is it?

A I do not know as to that really.

Q Well why do you readily agree with my assumption that the packing house company could sell for more than its cost, when you will not also agree with the assumption that the Royalite could probably be able to sell for more than the original cost also?

A Well for this reason, - for this reason amongst others, that the subject matter of the trade of the packing house represents an inexhaustible supply whereas the gas business to which you are presently referring, is geared to a specific supply of gas.

Q Yes, but we know that, if you rely on the engineers' opinions, it is going to last for 25 to 30 years.

THE CHAIRMAN: Mr. Chambers, I wonder if you would pardon me for a moment if I interrupt. Mr. McDonald is here now. Mr. McDonald, who are you calling tomorrow?

MR. McDONALD: My present intention is to start with Mr. Zinder tomorrow, and my present information is that I cannot go ahead with Mr. Denton at the present time.

MR. STEER: Then that creates a difficulty. I have arranged to have a witness brought from Pennsylvania, to be here for the 12th, because Mr. Zinder was being called on that date. Now he will not be here until then.

MR. McDONALD: I was only calling Mr. Denton because Mr. Zinder was not available, and now I cannot call Mr.Denton.

MR. STEER: I would like to have this witness here when Mr.Zinder is examined.

MR. McDONALD: I am quite agreeable to that. I was only trying to expedite the matter. That is quite agreeable if you wish, if you would make an arrangement of that kind.

THE CHAIRMAN: The furthest we can go tomorrow then is to qualify Mr. Zinder.

MR. McDONALD: That is as far as we can go.

MR. CHAMBERS: Are we going to have any other evidence tomorrow?

MR. McDONALD: No, I am not ready with anyone else,

except Mr. Zinder. I cannot be ready with anything further.

THE CHAIRMAN: That will possibly mean we will have nothing.

MR. CHAMBERS: Would it be possible to sit all next week and make up the time that is now lost?

THE CHAIRMAN: I am prepared to sit until next Friday if need be.

MR. McDONALD: I think Mr. Zinder's evidence will take one day in chief, and then of course it will depend on the cross-examination but I should think that four days should cover it.

THE CHAIRMAN: I am prepared to sit all next week. Perhaps I ought to let you know now that I am going to Toronto on the night of the19th , which is a week from next Monday.

MR. McDONALD: You will be leaving Calgary on the night of the 19th?

THE CHAIRMAN: Or Edmonton.

MR. McDONALD: That would give Mr. Zinder six complete days which I think would be sufficient.

MR. HARVIE: How long an adjournment do you expect there will be then from the 19th?

THE CHAIRMAN: I only expect to be in Toronto for three days, but even with that, that will mean the 27th before I can get home.

MR. STEER: You understand, Mr. Chairman, and perhaps it is working out just as well, that the appeals have been set down in Calgary for the week of the 26th, and those should be disposed of and perhaps they ought to be disposed of.

MR. BLANCHARD: Mr. Chairman, in view of the appeals is it the intention of the Board to sit during the week of the

26th?

THE CHAIRMAN: I will not be here.

MR.BLANCHARD: I thought you said the19th.

THE CHAIRMAN: No, I am leaving on the 19th and I will not be back until, at the earliest, the 27th.

MR.HARVIE: It will be December 3rd then that we will be proceeding again?

THE CHAIRMAN: Yes. That is fine, I am struggling to write a decision and if there is nothing to do tomorrow, I will not be very annoyed.

MR. McDONALD: There is one other thing, Mr. Chairman, we might mention here and it is this, I did want Mr. Hamilton to put in his evidence in chief on Part 9 of his report. Now if we could get an hour for that today, Mr. Hamilton will not have to return here next week at all.

MR. CHAMBERS: I do not expect to be more than an hour this morning.

THE CHAIRMAN: You require that, Mr. McDonald?

MR. McDONALD: Well either, - the exhibit is filed, all we are producing are figures which Mr. Hamilton has obtained and placed in his Part 9. If the figures can be used by us, that is by Mr. Zinder, without having them proved by Mr. Hamilton, that would be all that we would require.

THE CHAIRMAN: Oh, I suppose for regularity it would be better to have them put in by Mr. Hamilton himself.

MR. McDONALD: Yes, it would be more satisfactory, it would give a better appreciation of the evidence which we willhave.

THE CHAIRMAN: That would then mean deferring Mr. Hamilton's cross-examination on those figures until a later date?

MR. McDONALD: Yes.

THE CHAIRMAN: Has anyone any objections to that course being followed?

MR. STEER: I wonder.....

THE CHAIRMAN: Of course, I suppose the result would be that if Mr. Hamilton was not cross-examined and then if at a later date his evidence should be weakened or even destroyed by cross-examination, then that might have serious repercussions on the evidence given by Mr. Zinder, would that be right?

MR. McDONALD: Yes. All we are producing him for is to show a typical or factual demonstration. They are facts. They are taken actually from the books of the Royalite company.

THE CHAIRMAN: Yes. Now perhaps you had better give Mr, Chambers his last question, Mr. Cutler.

REPORTER READING: "Q. Yes. but we know that, if you rely on the engineers' opinions, it is going to last for 25 to 30 years."

Q MR. CHAMBERS: That was an observation which I made, Mr. Hamilton, in reply to your suggestion that the fact that the life of this product was limited, would materially affect the question of Royalite being able to sell this plant and equipment for more than it cost, allowing for depreciation? Now what do you say as to that?

A Well in my view the two situations are totally dissimilar. The Madison plant was an integral part of the Royalite operations, and even after severance at the creation of the Madison Company, it still retained some features of integration. More than that, it's operation is geared to the supply

of gas in Turner Valley and its rate of operation is geared to what the market will take, whereas in the case of the packing plant illustration its possibilities or we shall say opportunities for expansion are unlimited. Its life is unlimited. The two cases are not at all similar in my view.

Q Well what I am getting at is this, and I am putting it to you as a suggestion for your reaction, - this Board has to fix a present day rate or prices for present day services which are to be furnished, we have agreed on that?

A Right.

(Go to page 3864)

Q And I think you will agree that in doing so it is to allow to the Company and provide for present day operating expenses. That is one thing that must be taken into consideration ?

A That is true.

Q And also another thing, the present day rate of return ?

A Right.

Q And I am suggesting or what really occurs to me is why should not this Board take present day values to apply that rate of return too ?

A It is a very useful point of view and I think if I were convinced that the Royalite Oil Company could have sold its specific assets for a specific figure then I think that figure might possibly be the deciding consideration, but I do not think it is a realistic attitude.

Q Now just reverting to the packing plant for a moment. Conditions are changing in the packing business all the time ?

A Yes.

Q Especially in this country and in the west. The farmers in one year are into the raising of hogs and live stock in a big way and the price of wheat changes and they are into something else. Is that not right ?

A Right.

Q And the methods and kinds of machinery used in plants vary and are changed from time to time. Is that right ?

A Right.

Q But still with that in view you think that the two propositions are not analogous ?

A Right.

Q Now I would like to direct your attention comparatively briefly to working capital. Turning to Volume 1 of your Exhibit 124

as I understand it, WH 20 to 24 deals with Madison's working capital requirements ?

A 20 to 23.

Q Oh yes, 24 is B. A. 20 to 23, and on WH 20 read in conjunction with Page 11 of Volume 2 of your report you recommend total working capital of $140,000.00 ?

A That is correct.

Q And you make that up in this way; materials and supplies $93,134.16 ?

A Right.

Q Which is what Madison took over from Royalite or actually acquired ?

A Right.

Q And then for cash for operating expenses $36,047.77 ?

A Right.

Q And then you allow the margin of $10,818.07 ?

A Right.

Q Making a total of $140,000.00. Now then dealing with the cash for operating expenses on WH 20, you show average annual operating expenses of $446,727.76 ?

A Right.

Q And that is made up of $230,000.00 for payroll and $216,727.76 for other expenses ?

A Right.

Q And that excludes money paid out for gas purchases ?

A Right.

Q And now in Exhibit 74 which is Madison Report M-7, Mr. Kirkpatrick submitted that the Company should be allowed one-eighth of its average annual operating expenses of $451,560.81, or his one-eighth figure was $56,445.10. Do you recall that ?

A $56 -

Q $56,445.10 ?

A Yes, I remember that substantially.

Q Now your figure as I understand it recommends or is based on one-sixteenth of the payroll of $230,000.00 and one-tenth of the other expenses ?

A That is correct.

Q Now when the Company first commenced business in January 1944 I suggest to you Mr. Hamilton that it required in its business a certain amount of cash in order to meet its payroll as follows; on January 20th which is the -

A The first payroll.

Q It had to meet one twenty-fourth of its annual payroll ? It would need cash for that ?

A Roughly, yes.

Q And then two weeks later on February 5th it would need another one twenty-fourth ?

A That is right.

Q And on February 20th another one-twenty-fourth ?

A That is right.

Q And those three one twenty-fourths would be the one-eighth. It would require that amount before any monies were received on February 20th ?

A Presupposing the continuance of the present arrangement for collecting for their services. A change of two days in that would make quite a difference, but I am assuming that scheme is to continue on the present basis.

Q Is it generally recognized that one-eighth instead of a one-sixteenth or one-tenth is the usual and reasonable allowance in these matters ?

A One-eighth is a generally recognized rule of thumb fraction to apply but I think it is also recognized to err if it does err on the conservative side. I have seen one-eighth used quite frequently in utility practice and the suggestion I drew from the context was that while one-eighth is quite liberal now in this particular case of course there is this difference, that we have dealt with the particular matter before us and analyzed the situation to see what cash was required.

Q Well now aside from utility practice in particular, you have had a wide experience in dealing with the accounts and operations of companies that are in business generally ?

A That is right.

Q Would you not say that the average amount of cash working capital that those businesses require themselves or consider they require, would be in the neighbourhood of an eighth of those operating expenses ?

A I very seldom have seen that particular approach applied in ordinary commercial enterprise. The usual test as to the adequacy of working capital is the relationship of the total current assets to the total current liability. The amount by which one exceeds the other and the ratio of one to another. This approach of determining what fraction of estimated operating expenses is used in cases such as this for utility purposes and I have also seen it used in estimating the amount of cash that would be required for working capital in the starting up of a new business, but once business is under way I do not recall utilizing this concept at all.

Q Would you agree with me in this that well managed companies in their own private enterprise consider good business not to be niggardly with the amount of the working capital ?

A I think that is a moot point. A lot of very well managed business concerns endeavour to operate with the least possible working capital and I think that is a good test of good financial management.

Q But is it not a fact that well managed companies like to have a certain amount of funds available not only to meet their obligations directly on the dot, but that they can take advantage of buying at a discount and paying in cash and maybe buying when the market is right and so on ?

A No I would say this with all due respect that a good financial management relies much more on accessibility of credit than it does in having cash surplus of funds on hand.

Q You mean borrowing power at the Bank ?

A Or an arrangement with the trade for temporary accommodation one way or another. I think most businesses, you will agree with me on that, that the test of efficiency is not to have more money than you need but to get along with the least. In other words to use the funds you have with the greatest efficiency and get along with the least possible to do a good job.

Q But a company of this size, you do not necessarily suggest that they should adopt - and I am now referring to companies not under regulation - you do not suggest that for the purpose of working capital or funds to take the place of working capital, should adopt consistent borrowing policy at the Banks ?

A Depending upon what you mean by consistent borrowing policy. We were speaking a moment ago as to whether or not the having of ample funds on hand was a test of efficient management and I wanted to make that point clear. At the time I am not saying that thereare not efficiently managed companies that do have ample reserves. It is a matter of company policy. With

regard to this question of borrowing I think this, that good financial policy involves furnishing or the procuring of long term capital for that portion of its requirements which is stable and excess seasonable requirements are usually obtained from Banks or other sources of temporary accommodation. I think that is good practice and generally recognized so to be.

Q Well now Mr. Hamilton, do you know that in the case of the Valley Pipe Line when it was originally brought under regulation pursuant to the report of the McGillivray Commission, they recommended in the rate base, the working capital based on one-eighth, do you know that ?

A Yes.

Q And the Public Utilities Board on a hearing again a year or two ago proceeded on the same basis. I just wish to refer you to a couple of statements of one American regulated and one the other is from one of the Courts, and the first I refer to is re Detroit-Edison Company and it is before the Michigan Commission. It is reported in 1936,16 Public Utility Reports, New Series, Page 9 and the headnote that refers to working capital in effect says this:

> "The allowance for working capital of an electric and steam heating utility should not be niggardly in view of the fact that the utility cannot like the ordinary manufacturing concern shut down for lack of coal or other supplies but must be ready to render service at every hour of the day or night and all the time."

(Go to Page 3870)

Q You would not agree altogether with that statement then?

A Well it depends what you mean by niggardly. I do not think you should be niggardly in working capital allowance, or any other allowance for that matter.

Q What I am getting at is this: You have told me that one-eighth is often used, you think it is a bit generous, but now I am suggesting that if one-eighth is commonly used, that that might be the standard whether the allowance is niggardly or not?

A No, I think possibly this point of view should not escape attention, and that is when you have the opportunity or have not the evidence before you to calculate the requirements with exactitude, you are more inclined to utilize a rule of thumb method such as that, but where you have those figures, the facts and figures before you in a given instance, you can analyze your requirements of that particular concern and arrive more closely at what is required and that is what we have attempted to do.

Q Leaving aside for a moment or two as to what is the dividing line between niggardly and otherwise, would you agree with that statement as a proposition or principle to be followed, the allowance for working capital in an electric and steam heating utility should not be niggardly in view of the fact that the utility cannot, like the ordinary manufacturing concern, shut down for lack of coal or other supplies, but must be ready to render service at every hour of the day and night and all the time.

A Could I see that for a moment?

Q Yes?

A I do not think it necessarily follows. I think it is important

to insure that the supply of the service rendered by the company is not jeopardized by lack of funds. Now that does not necessarily mean that you would have to supply them with a super-abundance of working capital if alternative arrangements can be made more effectively and more economically.

Q Well, would this be a fair way to put it, you are not unreservedly prepared to agree with that statement?

A No, I do not think it follows.

Q Well then, the other one to which I want to call your attention for your reaction is Chiltenham Sewerage Company vs. Public Service Commission, which is reported in 1936, 15 P.U.R., New Series, page 99, before the Pennsylvania Supreme Court or the Superior Court, I am not sure which.

MR. STEER: Give me that citation again?

MR. CHAMBERS: Chiltenham Sewerage Company vs. The Public Service Commission, reported in 1936, 15 P.U.R. New Series, page 99, before the Pennsylvania Supreme Court.

> "A company ought not to be held down to the ultimate penny of its proved necessary balance, but there should be a reasonable margin of safety, and in the absence of evidence of mismanagement or inefficiency, experience of the company should have great weight."

What do you say to that proposition?

A I agree with it.

Q I am just going to place these before you and put them on the record because you may want to check them, Mr. Hamilton, later. I am not purporting to give evidence at the moment, but I made a note of several fairly recent decisions where they take in certain factors. In the Central Electric & Telegraph Company of Sioux City, 1941, 39 P.U.R. New Series,

366, before the North Dakota Commission, it based its cash working capital on six weeks for the operating expenses. You are not surprised at that?

A No.

Q And another one in North Dakota, the North Dakota Power & Light Company Limited, 1939, 31 P.U.R. New Series, page 26, also on six weeks' average expense. And then Cleveland and the Hope Natural Gas Company, 1942, 44 Public Utility Reports, New Series, page 1, the Federal Power Commission based it on 45 days, which is roughly one-eighth?

A Yes.

Q And in Detroit vs. The Panhandle Eastern Pipe Line Company, 1942, 45 Public Utility Reports, New Series, page 203, where the Federal Power Commission based it on 50 days excluding taxes and gas purchased, and the same rule, as I understand it, in another case before the Arkansas Commission, the Arkansas Power & Light Company vs. McGeekee, 1941, 42 Public Utility Reports, New Series, page 65. And then another Arkansas decision, the Twin City Pipe Line Company, 1941, 42 Public Utility Reports, New Series, page 29, they allowed 30 days for gas purchased and 45 days for other expenses. And then the last one, Montana-Dakota Utilities Company, a Montana decision, 1939, 31 P.U.R. New Series, page 229, they allowed to a natural gas company a one-eighth of the natural operating expenses. Now, as I understand it, you are excluding the gas purchased altogether?

A Right.

Q Now, what I am suggesting is this, Mr. Hamilton, that that is an element that you should take into consideration when you come to decide the fraction that you are going to use to

be applied only to the other expenses. For instance, the Federal Power Commission wasn't it, used 50 days, excluding taxes and gas purchased. In other words, I am putting it to you as asuggestion whether it would not be unfair for the Board to allow one-eighth especially in view of the fact of it disregarding or deleting from operating expenses, income taxez and gas purchased?

A Well with regard to income tax there is no necessity for providing working capital for that, Mr. Chambers.

Q No, but they did at one time, that was the practice at one time wasn't it, to take that into consideration?

A Not very generally, if my recollection serves me.

Q Well let us leave the taxes aside?

A I think we should because it has not any bearing on it at all.

Q All right?

A With regard to the gas purchased, I likewise think it should be and must be dealt with separately, and the Board will have to find whether or not this company has to finance the purchase of the gas. Now then, I appreciate your point that when you relate a one-eighth fraction applied to operating expenses including purchases, and compare that with another fraction related to operating costs exclusive of purchases, you disturb the comparison, but I do not think that we can derive any special benefit from the consideration of the one-eighth, unless we were able to demonstrate how that one-eighth is arrived at.

Q But, Mr. Hamilton, what I am getting at is this, that in view of the fact that we are excluding from operating expenses gas purchases that the fraction to be applied to those

operating expenses should be a little higher?

A Maybe a little lower, I do not know. You see, you have to find out really whether the persons' responsibility for the exercise of this fraction, the persons responsible for the exercise of this fraction were thinking that gas purchases required more or less working capital proportionately than other things, and I do not know how they get their one-eighth. It is just a rule of thumb.

Q That was one of my reasons for giving those cases and I would appreciate it if you would look into it, because we might want to talk about it a little later?

A Yes.

Q In any event, you will notice that the Federal Power Commission in two of the cases that I mentioned, adopted the one-eighth rule?

A That is right.

Q Now, is it fair to say this, that in reading the decisions of the Federal Power Commission, that they have the reputation as shown by their decisions of being or figuring pretty close as regards to the public utility companies.

MR.BLANCHARD: Surely that is not a question for this witness to answer?

MR. CHAMBERS: But he has done it.

MR.BLANCHARD: Is he supposed to study all these cases of the Federal Power Commission? I think it is rather unfair and not of much value.

THE CHAIRMAN: Yes. Go ahead, Mr. Chambers.

A Would you give me the question?

MR. CHAMBERS: You have read various decisions of the Federal Power Commission?

A Yes. I have not read anywhere near all of them but I have read a few of the outstanding cases.

Q And would you gather from those decisions that they have been less generous to the utility companies than was the fashion of the other Boards, that is the State Boards previously?

A Oh, I do not know as to that.

Q You do not?

A No.

Q All right.

THE CHAIRMAN: Would you like me to adopt the Federal Power Commission's idea in the consideration of the rate base, Mr.Chambers?

MR. CHAMBERS: No, but if the Federal Power Commission says one-eighth is fair, it must be, because they are not impartial to the utility companies.

A I did get this from it, I might say, that they felt they had been reasonable and lenient when they allowed one-eighth, that they were more than generous, from reading it.

Q MR. CHAMBERS: I think that is a fair way of putting it?

A Yes. There is another factor that should be taken into account there, too, and that is that you must always compare and relate the costs of the working capital with the benefits to be derived from it, and the lower the rate of return to be allowed to the utility company, the more reasonable it is to allow a larger amount of working capital. In other words, it is just like borrowing money from a bank. You can borrow money from a bank to enter into a certain operation, provided you can borrow the money cheap enough. The more expensive the money becomes the less profitable the operation becomes.

And, therefore, I say if the Federal Power Commission in allowing the 6% rate allows a certain amount of working capital, it might not be unreasonable to suggest that they would come to some other conclusion if they knew the capital was going to cost more money. In other words, if they were allowing say 10% interest.

(Go to page 3877)

Q In Exhibit 74 which was the Report M-7 filed by Mr. Kirkpatrick and on pages 7 to 10 Kirkpatrick deals with his estimate of Cash Working Capital, $100,000. Do you recall that, Mr. Hamilton?

A I am looking for the pages.

Q Pages 7 to 10, Estimated Cash Working Capital.

A Yes.

Q And on page M-7 C he arrives at that $100,000 as follows: He takes the Cash Working Capital for Direct Operating Expenses at $56,445.10.

A Right.

Q And he takes an allowance for Contingency Funds of $43,554.90.

A Right.

Q And that gives him $100,000.

A Right.

Q And on pages 9 and 10 he explains why the Company feels that it requires the Emergency Fund of $43,000-odd. Now on the other hand, you allow for the Emergency Fund a sum of $10,818.07.

A My $10,000 is not an Emergency Fund. It is a General Allowance.

Q I see, yes.

A I specifically do not provide for emergencies.

Q And you will recall that on pages 9 and 10 of Exhibit 74, Kirkpatrick speaks about periods of peak operation and talks about prepaid expenses and he talks about Rate Hearing expenses.

A Yes.

Q Now where do you suggest that the Company should obtain those funds for those purposes, I mean the actual amount it has to pay out.

A Well except for a very short period of time at the beginning

of the year, taking each year separately, the Company has ample funds on hand from the operations, along about March and April and from then on they have a lot of money. They have depreciation funds and profits which they have not yet paid out that would take care of these expenditures.

Q But I would suggest this and we know that is the period of peak operations in each year, the early months of the year.

A That is true but the flow of cash outward from the examination I made was fairly continuous throughout the year. That is if you actually count the bills going out it is remarkable how even that flow is throughout the year. Revenue reflects a substantial variation and fluctuation from one time to another but the expenditures do not reflect that condition.

Q Now I am instructed, and probably you know that some of these items of prepaid expense are an insurance bill for three years of around $18,000. That is a fairly sizable amount. Did you run across that amount?

A Yes.

Q In your investigation, and as I understand it they pay, roughly, $1,500 for six months to the Workmen's Compensation Board.

A Yes.

Q And they pay around $2,000 for Unemployment Insurance stamps for six months or thereabout.

A Yes.

Q And there are such things as car and truck licenses.

A Yes.

Q And there are office supplies and books and so on and things of that nature.

A That is right.

Q And then there is this question of Rate Hearing expense.

A I wonder if I could make an observation in regard to the insurance before we pass on.

Q Yes.

A It is a useful illustration of the point I was trying to make a few minutes ago. I think there is a clear-cut principle which is recognized with regard to providing finances for any concern. Good financial management will compare the cost of obtaining a particular sum with the use to which that sum can be put. The cheaper you can raise money the more use you have for money and I would say that the rate of return to be allowed in this instance would have no bearing on the amount of working capital to be provided because the higher the rate of return the more expensive these items become with regard to the prepaid insurance and of the necessity of a provision in working capital to pre- the insurance for three years in order to get the discount, it becomes unprofitable at a 15-5/8% rate of return. I would say that the higher rate of return would offset the benefit to be obtained by prepaying insurance for three years in order to obtain the discount.

Q You say that it breaks about even?

A Yes, it breaks about even.

Q Then there is a question of Rate Hearing expense and frankly I have not been able to follow it through but that will probably be greater in the first years of operation.

A Yes.

Q Assuming the rate does provide for the money to be provided for in the rate to be charged, the fact remains that the Company has to supply the money throughout the period of these Hearings.

A Right.

Q Lawyers and even Chartered Accountants are not going to wait until the end of the Hearing, when the money is collected by the Company from somebody. What is your idea about that?

A First of all this Rate Hearing cost is analogous to the Girbotol prepaid royalty. I think they are pretty well on the same footing. They represent substantial outlays at the present time that will be amortized over a shorter period than the life of the field. Now my position with regard to the prepaid Girbotol royalty is that it has to be included in the over-all rate base as an adjunct of the working capital allowance of $140,000 which I recommended. That is a treatment in accord with the submission of the Company. If the amount to be prepaid on the Rate Hearings is substantial then perhaps a similar allowance could be made in that regard. But I suggest this that single items which will have some significance in the early days of this Company's operations should not enter into the calculation of Working Capital Allowance for the entire period of its operations.

Q I quite agree and what I am suggesting is that in fixing Working Capital for the first four or five years there might be and the Board probably should be more generous than it would be later on after these things are found out and the Company is operating without having to have Rate Hearing expense.

A That is right. I am quite prepared to recognize Rate Hearing expense as requiring additional Working Capital but my reason for not wanting it in the Working Capital Allowance is that I would be just a little afraid that you might forget why it was there.

Q I quite agree that if Working Capital is increased by

virtue of that alone there should be some very clear-cut statement showing that it is for a temporary period.

A I have no quarrel with that.

Q Now in WH20 of your Exhibit 124 in arriving at the Annual Cash Expense you deduct certain items from the total expenses as being non-cash. That is right is it not?

A Right.

Q Now why do you deduct that last item of $20,000, provision for contingencies.

A Now then the $20,000 was the allowance made by the Madison Company in computing its expense estimate for the years 1944 to 1948. Now those expense items were made by the Madison Company and this exhibit of ours to which our attention is now directed, were all made before the end of the 1944 operations of the company and the company provided for $20,000 additional expense so as to allow for underestimates of expenses and I eliminated that. I am prepared to admit that for the year 1944 in any event the provision for contingency is proper.

Q That is the actual experience of the Company.

A Which confirms the propriety of the provision, yes.

Q That concludes my examination and I desire to apologise to Mr. Hamilton for having taken the time that I have but at the same time I want to say that I have enjoyed every bit of it.

A So have I.

.....

CROSS-EXAMINATION OF THE SAME WITNESS BY MR. FENERTY.

Q Mr. Hamilton, in connection with this matter of working Capital that has just been taken up, your recommendation I see at page 16 of Part 2 of Exhibit 124, your recommendation as I understand it is an allowance of $140,000 instead

of $190,000, with a suggestion for borrowing the difference of $50,000 from the bank, is that right?

A Oh no. I recommend $140,000 and the Company recommends $190,000. I say that I think the $140,000 will carry them except for exceptional circumstances and then they could borrow that if they have to. But I do not recommend that they go and borrow the $50,000 right now.

Q Pardon me. In your graph on page, statement 21, WH 21, it shows the position and where the overdraft crosses the income in the event of no allowance for Working Capital.

A That is right.

(Go to page 3883)

Q Now perhaps I am a little confused here, let me turn again to the bottom of page 16 where you referred to:

"It would appear to us reasonable to suppose that temporary accomodation would be readily available from the Company's bankers, should it in fact ever actually be required. Such a resort would, in our opinion, be preferable to the provision of an additional $50,000 which would represent just so much additional surplus funds on hand for the remainder of the year at a cost to be included in the service rate of approximately $7,900 per annum."

Yes, I see. Well now in view of the fact that funds would be required for quite a limited time, would they not, Statement WH-21, could that all be taken care of, do you think, by way of borrowing from borrowings from the bank?

A It could be, yes, provided that arrangements could be made. On the other hand I do not think the Company should be asked to borrow for its initial inventory of materials and supplies and cash requirements for operating expenses.

Q Assuming the Company's position is such and the contracts are arranged in such a manner that the income is in the way indicated by these charts, do you see any objection to borrowing, assuming of course the Company is in a financial position to do so.

A None whatsoever.

Q What?

A None whatsoever.

Q And that would avoid a considerable burden?

A Quite right.

Q On the rate base and on the ultimate consumer?

A Quite right, and it would be efficient financing too.

Q Yes. Then what is the effect of carrying over the position to the next year, do you not have a carrying over of surplus funds there for the next year?

A Well as I remarked a moment ago, I was dealing with each year on its own feet.

Q Yes.

A Or foot.

Q That is what it is.

A Now I might suggest this, that we are talking about the rate or will be talking about the rate of return per annum, which presupposes that the rate of return will be a return annually and precisely on the last day of the year.

Q Yes.

A Similarly, we are speaking about the retirement of the rate base by depreciation; that likewise is dealt with on an annual basis and is returnable on the last day of the year. Actually there will be a lag in the actual payment of the dividends, both capital dividends and earnings, which will in fact cover or help to cover this overdraft situation at the beginning of the year but I do not think that the Company should be put in that position, because it is entitled to that money on the 31st day of December and if they chose to pay their dividends then they would be entitled so to do.

Q But as a matter of practical working out of the situation it is this, that the whole thing could be taken care of by borrowing at the initiation of these transactions of sums of money from the bank for a period of from January to the latter part of March.

A The latter part of April.

Q And thereafter, thereafter, the situation takes care of itself. It is a process of money coming in, expenses being paid out and in the normal course payment of dividends.

A That is right.

Q And is there any particular way that anybody would be hurt by that kind of set-up?

A It exposes the investor to a slightly higher degree of risk because the outstanding obligation in favor of the bank ranks ahead of the investor's.

Q We are speaking now of the utility which will have definite payments coming in and definite payments to be made and rates which will provide for all those contingencies, that does not provide a banking problem of any kind does it?

A Well . . . . .

Q I mean there is no banking problem about the borrowing?

A Oh I think they would be able to borrow very readily.

Q And there is no problem so far as the shareholders are concerned on the basis of the facts you have given me as to what they are?

A Yes, but I do say this, you ask me if anyone would be hurt at all and I say the shareholder is subjected to a slightly higher degree of risk because of the outstanding obligations to the bank which would have priority but for practical purposes I do not think it is important.

Q THE CHAIRMAN: Does it not involve, Mr. Hamilton, that the Board is stepping into the question of management and telling the Company how to run its affairs.

A That is right.

Q And I wonder if that is a proper function of the Board.

A Mr. Fenerty asked me if they could do it, I think they could do it, I am not suggesting that they should do it or be made to do it.

Q MR. FENERTY: Now coming to another matter, Mr. Hamilton, I was rather interested in your suggestion to Mr. Chambers, found at page 3758 in the evidence, near the bottom, seven or eight lines from the bottom:

"Q. Is it not usual in those cases for the tribunals to allow something for what they call compulsory taking?

A. Yes sir."

Perhaps I should go further back, to the question before that:

"Q. Where the Government says in the public interests or for some other purposes a certain amount of property or piece of property that you own, we want to take that from you and there is provision in the Statute to enable them to do that and there is usually a Tribune set up to decide what the fair compensation is. That is right?

A. Yes sir.

Q. Is it not usual in those cases for the Tribunals to allow something for what they call compulsory taking?

A. Yes sir.

Q. Because they assume that the vendor or the party whose property is taken does not want to sell?

A. Or might not want to sell."

And then this question:

"Q. Your rate base does not give any effect to that?

A. Yes I think it does."

Now I suggest to you that there is a certain confusion of thought there, that the case which Mr. Chambers was putting to you has nothing in the world to do with the determination of a value for a rate base in a Public Utility Enquiry, - you see it was founded on the compulsory taking of a property and I suggest to you that in a public Enquiry, a Public Utility Enquiry that so far from considering those elements which are taken into consideration in condemnation proceedings or expropriation proceedings, having to do with the recognition of compulsory taking, that those are things which should not be considered and I want to refer you to a reference in a text and see whether it meets with your approval. . . . .

A Was I supposed to answer that yet or do you still want to go on?

Q I am suggesting to you that you should not have given any value or any allowance to the Madison Company on the basis that their property was being taken compulsorily or that you should not apply any rules which are used in valuing in compulsory taking, to Public Utility property.

A I quite agree there is an entirely different situation in expropriation or condemnation proceedings and I think I tried to make that clear but that does not necessarily mean that there may not be principles which are applicable to both.

Q Well I want to refer you, - you have been referred to decisions in text books and I want to refer you to this decision in this text book, in Bauer and Gold, page 22, dealing with rate bases:-

"A rate base must be determined before the rates

"are fixed, and cannot be dependent upon the rates. It requires criteria other than rates or earning power. It is rather the measure of earning power to be allowed through public policy and must, therefore, be predicated upon factors and considerations other than rates and earning power. It involves relative fair dealing with investors and consumers, together with other positive purposes of the state in dealing with utilities in the public interest.'

That is just a preamble to the part to which I want to refer:

'The lack of clear distinction is understandable among lawyers and even engineers and accountants,'

and I do not like that way of putting it but here it is in the text:

'who have not been trained to precise economic conceptions. Courts have at times been misled by condemnation analogies which naturally were brought to bear upon public utility valuation. Often in condemnation procedure, physical valuations are made as substitutes for market values. And for rate making, likewise, physical valuations have been necessary in the absence of a definitely established rate base. Doubtless the similarity of procedure has been partly responsible for confusion of categories involved. In condemnation cases, however, the object is to determine the commercial value of the property, either as shown by actual market transactions, or reasonably derived through various considerations where there are no market data. In rate making there can be fundamentally

'no consideration of market value; the object is the establishment of fair dealing and carrying out desirable public policy."

Would you be prepared to agree with that?

A I think so. You read it a little fast for me.

Q You think so and I hope so.

MR. CHAMBERS: What are you reading from now?

MR. FENERTY: Bauer and Gold. (hands book to Mr. Chambers).

MR. HARVIE: Page what?

MR. CHAMBERS: Page 22.

Q MR. FENERTY: Now Mr. Hamilton, in the matter of the basis of valuation in Exhibit 125, you point out at the top of page 2 a statement which Mr. Hill made, you say:

"Mr. Hill in his evidence I believe stated that reproduction cost was one, but only one approach, and that it was quite proper to suggest the Board might have regard to other factors or other approaches."

And as we have heard a number of times during your examination, my understanding is that in view of the special facts or the facts of this particular case you lean to the theory of adjusted historical cost, perhaps that is right.

A For the gross.

Q Yes, for the gross.

A Yes.

Q Yes, and that gives you the figures set out in Exhibit 124, Statement WH-1A at the bottom, that is 1,573,668.

A Well it will give you any one of the last four, depending on which type of depreciation you apply.

Q Yes, well I am going to come to the others.

A I wanted to be sure whether you are talking about the gross valuation or the net.

Q I am going to come to the depreciation later but this question of historical cost, there have been a good many quotations and citations put to you with reference to the desirability of replacement costs with observed depreciation and so on, and might I have that volume again, I hope I am going to get it back.

THE CHAIRMAN: Perhaps I had better take it away from all of you.

WITNESS: Would you read this one a little slower, Mr. Fenerty, please?

MR. FENERTY: Yes, I am sorry.

(Go to page 3891).

Q At Page 110 we find this comment dealing with the recognition of Courts of the establishment of fair value on the basis of reproduction costs:

> "This virtual recognition of reproduction cost as the chief criterion of fair value was established during a period of high prices when not only the Court but also economists and financial leaders mostly expected an indefinite continuance of the prevailing high plateau".

And you will remember Mr. Chambers' examination of you the other day leading to the suggestion that we might expect a continuation of prices on the high plateau, that is just about the way he took it ?

A Yes.

Q This volume was published in 1934 and I suggest to you we have a remarkable reproduction cycle.

> "When the Supreme Court had reached a clear feeling as to future prices and had, therefore, established reproduction cost as the controlling, if not the sole basis of valuation, prices soon started downward with a swoop. What the future course will be, no one can prophesy even with approximate assurance".

And of course I take it you will agree with that that what the future will be here no one can prophesy with any degree of assurance ?

A Right.

Q And you have I take it read a good deal on this question of Public Utility practice ?

A Yes.

Q And as a result of reading these cases I wonder if you came to the conclusion somewhat similar to what I came to that in an

era of rising prices those who would benefit by the establishment of a theory advocating reproduction cost with or without one or more systems of depreciation and those who would suffer by that advocate historical costs and that in eras of falling prices you find exactly the reverse of that situation. Did you gather that from reading the cases ?

A That suggestion did not occur.

Q That is just human nature and that is what happens on both sides ?

A I said that suggestion did not occur to me.

Q It would be interesting if you would read some of these authorities in the light of that and what happens in these cases where there are rising prices. One side advocates reproduction costs and the other side contests it. Where there are falling costs the one side advocates historical costs with allowance for depreciation and the other side contests it ?

A I was concerned with the logic or the reasoning of the propriety of one method against the other without regard to the motive.

Q But the history of utility practice has been and I suggest to you on reading the text that it discloses that and this applies to both sides, not only the utility but to the public, the advocacy throughout of one theory or the other depending upon whose ox is gored. That is what happens in the history of utility practice. Have you gathered any such conclusions from the reading of the text and the cases. I will put it this way. That in an era of rising prices the utility would advocate reproduction cost . In an era of falling prices the same utility has advocated historical cost . In an era of rising prices thus seeking to whittle away the utility rates, have advocated reproduction costs and in an era of rising prices they advocate historical costs and in an era of falling

prices they have advocated a reproduction cost. That is just the history of these cases ?

A I do not know. I have never seen any particular utility switch horses.

THE CHAIRMAN: I put it to you in another way Mr. Hamilton. I had the same thought and had a note on it. Suppose price levels today were below what we might call normal and if historical costs should be greater than reproduction new which would you recommend the Board should follow ?

A I would recommend the historical cost and undoubtedly the company would too.

Q I think so.

MR. BLANCHARD: It might be summed up in the trite saying that human nature is the same the whole world over.

Q MR. FENERTY: Now I was interested also in reading in the booklet Principles of Depreciation my friend Mr. Chambers referred you to in his cross-examination, and in that same document I find comments by the American Society of Civil Engineers, and on the first page of the report of the Committee on depreciation, of the National Association of Railroad and Utilities Commissioners and it has also been referred to as N.A.R.U.C.:

> "By far the largest part of that report is devoted to the purely accounting phase of the subject and to detailed discussions of various methods, straight-line, sinking fund, compound interest and so on."
>
> "That report when analysed recommends that annual depreciation expense be calculated by the straight-line method of distribution, using as a basis for the distribution the average lives of groups or units of property."

Then turning the page;

"The Society's Committee while fully recognizing the usefulness of the straight line method in accounting for unregulated industrial property and possibly for certain utility property, does not believe that its use is proper in the case of the great majority of utility property;"

I am referring to that as illustrating the fact that you find here differences of opinion between Civil Engineering Societies and the National Association of Railroad & Utilities Commissioners as to the proper methods of approaching these problems ?

A That is right.

Q You realize you have had those differences throughout and on one other occasion I took occasion to refer to an analysis made by Mr. Justice Brandeis of the Supreme Court of the United States at Page 504 of Barnes "The Economics of Public Utility Regulation", presented a summary analysis of the predominent element in the determination of the rate base in 363 Commission cases reported in the Public Utilities Report from 1920 to March 1, 1923. I am going to repeat some of them to you;

In five cases: reproduction cost at unit prices prevailing at the date of the valuation.

In twenty-eight cases: reproduction cost at unit prices prevailing at some date, or the averages of some period, prior to the date of the valuation.

In twelve cases: reproduction cost at unit prices prevailing at some date not specifically stated.

In twenty-two cases: reproduction cost of an inventory of a prior date at prices prevailing at that date or prior thereto, plus subsequent additions at actual cost .

# I N D E X

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## W I T N E S S E S

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ROBERT WINSLOW HAMILTON (Continued)


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: : : : :

In three cases: reproduction cost on basis of future predicted prices.

Now there you have five, twenty-eight, twelve, twenty-two, three, cases of reproduction cost with some variation in the date when prices were determined. Then 102 cases of prior valuation by the Commission plus actual cost of subsequent additions.

In 85 cases: the actual original cost including both initial cost and additions.

In 6 cases:original cost arbitrarily appreciated.

In 27 cases: the historical cost or prudent investment.

In 28 cases: book cost or investment.

In 12 cases: bond and stock capitalization.

In 36 cases: determination and classification of method impossible.

I suggest to you an analysis of Utility Commission cases carried out later would indicate similar divergence of opinion notwithstanding the decisions in the Hope case and the Smith case. Now have you gathered from your reading of texts and cases, a clear indication that both Courts and Commissions in the United States in dealing with the methods of arriving at valuations and the methods of depreciation were concerned with the powers and the possibility of any method interfering with contractual rights might lead to a constitutional problem such as we do not have in our country. Did anything like that occur to you in your perusal of the authorities ?

MR. BLANCHARD: Mr. Chairman, I think it is very interesting to us to have the excerpts from these books and from Barnes read into the record but I doubt if Mr. Hamilton as an Accountant can help my friend Mr. Fenerty. I do not want to necessarily object.

THE CHAIRMAN: I think it is taking him a good deal out of his proper sphere, but I have been waiting for someone to object before I would do anything about it. I am not taking the initiative in matters of that kind.

MR. FENERTY: I will admit we are all being very complimentary to Mr. Hamilton as a layman in the law, but I thought perhaps on these backgrounds not only of mine but of my friend they might be of some assistance.

MR. BLANCHARD: I am not objecting to my learned friend reading these into the record at the present time. I think they are all useful but I am saying it is not for the witness.

MR. FENERTY: Well I have transgressed probably but I shall keep within bounds.

Q I would like to refer you to a statement this time in the Public Commission point of view as expressed in the review of depreciation by the Public Service Commission of Wisconsin, or rather the staff of that Commission, Page 45:

> "Original cost, disregarding its legal status is in our opinion the logical and administratively sound basis for accruing depreciation. If the patrons in whose service property has rendered its service life are charged with the actual investment in that property, they have fully reimbursed the Utility for its loss in rendering that particular service. The consumer of today pays the cost of sercice to him and not the expense incurred in serving a later generation".

Would you agree that is a proper consideration of law ?

A It is a useful point of view. I do not adhere to it exclusively.

Q "And with actual cost as a base, accounting at least approximate facts and is not converted into a system of weird guess work".

I do not know whether you would apply that phraseology as weird guess work to this other system ?

A I would not.

Q You would not go that far ?

A No.

Q I did not think perhaps you would.

"The life of property is uncertain enough and this causes sufficient disturbance to depreciation estimates without introducing something that cannot, by present knowledge, be foreseen. Who knows what it will cost fifteen years hence to replace a trolley car or a certain type of turbo-generator unit, or, for that matter, whether they ever will be replaced?"

That seems to be a cogent comment here.

"In dealing with actual costs, we dwell in the realm of fact and are not compelled to fly into imaginary spheres".

Perhaps that is a fair statement that last one ?

A Yes.

Q You do not want to fly into imaginary spheres do you ?

A No.

MR. BLANCHARD: I do not know whether you are not taking him there.

THE CHAIRMAN: Perhaps during the adjournment or while we are here we ought to discuss the propriety of putting in Part 9 by Mr. McDonald of Mr. Hamilton's evidence.

(At which time a short adjournment was taken)

( Go to Page 3898 )

MR. FENERTY: If the Chairman pleases, it was the wish of Counsel and for the convenience of the witnesses, I am quite willing to adjust myself any way you see fit. However, I would like to ask about two questions to complete the thing that I was on.

THE CHAIRMAN: All right.

MR. FENERTY: So that we will finish with this, and then I will hold the balance of my cross-examination.

Q Mr. Hamilton, I suggest to you that having in mind the diversity of methods which have been employed in utility cases, and which have been recognized as permissible and proper under the circumstances of the individual cases, having in mind the special provisions of the Act under which we are operating, which permits of various methods being employed in determining a fair value, and a just and reasonable result, and having in mind the special facts of this case, what you have done is, you have sought to employ a method or methods, both in determining values and in arriving at depreciation, which, to your mind, gives a fair and just and reasonable result; that is about the thing, without being bound to any particular method, because it was applied under one set of facts?

A That is right.

Q The method that you have adopted is adopted because of the leeway allowed by the Act and your conception of what is just, fair and reasonable under these particular facts in this case here today?

A I have not adopted a rate base.

Q I beg your pardon?

A I have not adopted a rate base. I have suggested a number of methods.

Q A method?

A And I have recommended one of those as appealing to me as being the most fair and the most reasonable.

Q I am not speaking of the rate base, I am speaking of the method of arriving at it. You have adopted those methods which have been referred to in various cases, which seemed to you to meet the circumstances of this particular case. That is what you have done, isn't it?

A Well I have suggested or pointed to a number of different methods.

Q Yes?

A And of those methods I have recommended one which seemed to me of those various methods to be most fair and reasonable.

Q Because of the facts of this particular case?

A That is right.

Q That is all for now.

.....

DIRECT EXAMINATION BY MR.BLANCHARD

Q Mr. Hamilton, I believe as part of Exhibit 124, you prepared a certain statement or calculations in connection with gas cap wells wholly owned by Royalite for the purpose of indicating cost of producing gas in those wells?

A That is correct.

Q And that forms Part 9 or Section 9 of Volume 2 of Exhibit 124?

A That is correct.

Q And the calculations are set out in statements, I think, WH-57 on, and by the way there is an error on page 49 of Volume 2, it should be 57 to 64 and not 67 to 64?

A That is right.

Q Which is quite obvious?

A Yes.

Q Now will you please read into the record your remarks and explain the calculations made by you please?

A Our comments respecting the operating results of gas wells commence at page 49 of Volume 2 and read as follows:-

> " With a view to affording the Board some indication of the cost of producing gas, we have prepared certain calculations in connection with the gas cap wells wholly owned by the Royalite Oil Company Limited. These computations are contained in Statements WH 57 to 64 inclusive, and the following comments relate thereto.
>
> In connection with an examination of the records of the Royalite Oil Company Limited for the year 1943, we prepared completely departmentalized operating statements and submit herewith as Statements WH 57 and 58 the operating results of the wholly owned Royalite crude wells and the wholly owned Royalite gas wells."

Perhaps we might look at those two statements now. I might say that this term "wholly owned" there is intended to cover those wells in which Royalite has 100% interest and control, and there has been excluded for obvious reasons, those wells of which we only know part of the story. In other words, unless it was a wholly owned well, it was not included in this particular part.

Statement WH 57 presents the operating results of the crude wells and 58 the gas wells. And, taking 57 first, you will observe that of the wells there listed, the

total revenue derived mainly from the production of crude oil is in the amount of $1,079,487.11. There was a small amount of revenue from gasoline extraction and from the disposal of residue gas. After deducting from the combination of those revenues, the royalties that were charged up of $124,087.71, the revenue less royalties for those wells amounted to $978,006.20. On the right side of the statement is a summary of the expenses comprising operating costs of $180,491.61, general expenses of $12,405.88, and for the retirement of investment an amount allowed of $515,884.22, making a total expense of $708,871.71, which when compared with the total revenue less royalties which I have previously referred to, the net income from those wells on those facts amount to $269,224.49. I should state here, however, that the figure of $515,884.22 for investment retirement is on the basis of the provision made by the company, and it is in that particular year or for that particular year. You will find later that we have deemed it necessary in connection with the gas wells to substitute for the type and amount of investment retirement provision a totally different figure based on a different approach.

Turning to Statement WH-58, we have a similar presentation for gas wells and a comparison of the two shows some rather interesting results. It will be observed that the revenue in these wells is derived largely from the disposal of residue gas, to a smaller extent from the share of the gasoline extraction from the wet gas, and to a very minor degree from a disposal of crude oil. The total operating expenses amounted to forty-three thousand odd dollars, general expenses a further three thousand odd, and investment retirement, here again based on the company's own type of provision,

two hundred and forty-four thousand, eight hundred odd dollars, making a total expense for the year of two hundred and ninety-one thousand odd, which, when compared with the revenue less royalties reflects a net operating loss for that year of twenty-seven thousand odd dollars. Here again, of course, the net income would be changed upward or downward according as you change the amount of investment retirement, and this is predicated on the company's own provision and not on one of ours.

Turning back to page 49 of Volume 1, I mean Volume 2, it is page 49 of Volume 2.

A comparison of these two schedules will indicate that in the case of the crude wells, gasoline extraction and residue gas amount to roughly 2% of total revenue, and may, therefore, be considered as purely incidental income; in the case of the gas wells, however, the reverse situation obtains, with crude oil revenue representing less than 7% of total revenues. From the point of view of cost accounting, therefore, it would seem reasonable to consider gas as a by-product of those wells classified as crude, and crude oil as a by-product of those wells classified as gas wells.

Of course, there will be borderline cases.

Apprehending that certain circumstances tend to distort the operating results of the gas wells in 1943, we have prepared Statements WH 60 and 61 to indicate the probable operating experience of the Royalite wholly owned gas cap wells on the basis of certain assumptions.

Statement WH 60, is designed to

indicate the results of operation of the Royalite wholly owned gas cap wells assuming 1944 price and production equivalent to the 1945 share of the market as estimated by the company (namely 3,519,439 MCF residue basis). On this basis gross revenues would amount to $105,896.30 including the estimated value of crude oil produced, and natural gasoline extraction based on absorption plant statistics for the year 1944.

That is as compared with $212,746.00 actual for 1943. Pardon me, as compared with two hundred and ninety thousand actual for 1943.

Deducting the royalties of $9,451.25 would leave an amount of $96,445.05, to cover costs of $97,297.18, resulting in a net loss of $852.13. Costs are made up of $47,091.18 operating expenses and $50,206.00 provision for investment retirement.

I am not dealing with 59 for the moment. I am skipping that to go to 60, which we are talking about now. You will find there the sum of estimated revenue predicated on our assumptions, first of all, of a two cent price for residue gas, and the other prices for gasoline, extraction and crude as indicated there, and assuming also a rate of production of three and one-half milion roughly, as estimated by the Company, at the time these calculations were made, to represent the probable production from these particular wells for 1945.

Operating expenses of $47,091.18 is based upon the cost of operating the Royalite gas wells in 1943 as per Statement WH-58, subject to minor adjustments applied in WH-59, to relate the costs of operation to the specific wells included in field reserve estimates furnished

to us by the company for the gas cap.

Those assumptions are not important but their purpose was to convert the operating expense reflected on 58 to the particular wells included in the reserve estimates and production estimates we are using in Statements WH 60 and following.

(Go to page 3905)

We are assuming in this connection that operating expenses will remain constant irrespective of the volume of production. The amount so provided includes provision for the cost of services furnished by other departments and administration. We recognize, however, that this cost reflects certain savings due to the operation of wells on a joint basis. I should also emphasize at this stage that these costs, operating costs and general expenses which we have allocated to gas wells are not the costs necessarily which the Company had themselves applied or might have applied. It is our treatment of the total over-all operating cost of the Company for that year, broken down by departments and then finally within the production department broken down between wholly owned wells and partly owned wells and other production department activities. But the allocation was ours, based on the total operating expenses of the Company for that year.

Provision for investment retirement includes depletion of leases, depreciation of producing wells equipment and amortization of drilling costs. In this connection, the aggregate amount of $50,206 stated as expense of investment retirement, comprising the three foregoing elements is arrived at as follows:

(1) The gross investment to be amortized over the entire life, past and future, has been determined in the amount of $6,339,893.02 made up as follows: Leases including $225,760.48 for undrilled acreage, $1,180,178.65; producing wells' equipment, $1,345,683.12; drilling costs capitalized $3,814,031.25, making the total to be amortized. $6,339,893.02.

That was our first step to arrive at the gross amount of capital expenditure which had to be amortized from the beginning.

(2) The gross investment as above determined, has been amortized on the basis of total estimated production, past and future, of 501,326,910 M.C.F. arrived at as follows: Total production of these wells to December 31, 1943, according to the Company's records, was 631,783,677 m.c.f., from which we deducted that part of the production to date which had occurred prior to the acquisition by the Company of some of these wells. That deduction was 308,914,767 m.c.f., so that the production by the Royalite Company from those wells to December 31, 1943, its effective production to that date would be 322,868,910 m.c.f.

The point being that we have excluded from the effective production that portion of the production which occurred prior to the acquisition by the Company of these properties, in some cases. To that, we have added

The Estimated reserve remaining at December 31, 1943 which the Company officials were kind enough to give to us at our request and of course it is just an estimate of 178,458,000 m.c.f.

So that the Company might be said to either have had the benefit of or can expect the benefit of a total production from those wells of approximately 501,326,910 m.c.f. Now in statement WH-60 we have assumed a certain production and consequently we have related the amount requested for amortization to well costs and for

all depreciation and depletion a certain amount in relation to that amount of production.

(3) Assuming a market share of 3,510,439 m.c.f. and relating this back to a requisite withdrawal of 3,970,038 m.c.f. would indicate a retirement cost of 1.2646 cents per m.c.f., or $50,206.00.

I am sure that we all appreciate the course of this calculation. The total investment was $6,300,000 and the total production is going to be or has been 500 million, so that that works out to a rate of approximately a cent and a quarter for capital expenditure for the life of the field or the life of the wells.

It would, therefore , appear that at a rate of withdrawal of 3½ million m.c.f. per annum and assuming also prices as presently prevail, revenues fall just short of meeting expenses without provision for any return on investment, but it does provide for the return of the investment.

We have presented as Statement WH-61 the estimated operating results of the same wells on the same basis but assuming a production of only 1,042,488 m.c.f. residue basis, which we are informed, is the approximate anticipated production under a proposed scheme of conservation - perhaps we should substitute there the term "conserved gas scheme" - to permit gas from crude wells to go to market where possible instead of being repressured. From this statement it will be observed that on the basis of this reduced output, operations result in a loss of $33,395.03. I am allowing a moment if anyone would like to look at WH-61. Then we pass on. The reason for the increased loss, of course, is the fact that we have assumed

that the operating costs will remain constant and therefore diminution in production is bound to operate unfavorably. This comparison raises certain questions in connection with the cost of withholding production, which will no doubt be receiving the attention of the Board in another connection. This might have some bearing on the problem, financial problem relating to the conserved gas situation. However we can deal with that later.

To demonstrate more fully the effect upon operating costs of varying the rates of production and varying prices for residue gas, we submit Statements WH 63 and 64. Statement WH 63 shows the resulting profit or loss, assuming various volumes of production ranging from 1,000,000 to 12,000,000 m.c.f. residue basis, but assuming present prices to prevail. From this it will be observed that a loss of $33,952.00 is sustained at 1,000,000 m.c.f. production level, whereas a profit of $110,570.00 results from a production of 12,000,000 m.c.f. per annum, the profit increasing by approximately $13,000.00 per million m.c.f. This statement is merely indicative on what order profits change with varying production. I doubt whether the figures for the different levels are sufficiently precise to be useful for anything more than getting a general idea of what happens when production varies.

Statement WH-64 presents in tabular form the net result of operation for annual production ranging from 1,000,000 to 12,000,000 m.c.f., and for residue gas prices ranging from 1¢ to 10¢ per m.c.f. The previous table merely showed the changes that occurred in operating profit as a result of this varying production. This table 64 shows the effect of varying production and/or varying prices and

of course the fluctuations are much wider. This table indicates that at a 1¢ residue price, production must rise to 12,000,000 m.c.f. to cover expenses; at a 2¢ price, production must rise to 3,500,000 m.c.f. in order to cover expenses. At 3¢, production must be maintained at slightly over 2,000,000 m.c.f. in order to cover expenses. At the other extreme, with a 10¢ price for residue gas and production at 12,000,000 m.c.f., an annual net profit of $984,980.00 results. That is subject again to the same comment I made a moment ago, the same reservation.

To give an indication of the return on investment represented by the various operating profits reflected in the table, it might be assumed that the future average investment in these wells will be one-half of the present unamortized cost of $2,256,820.06, or an average investment of $1,128,410.03. On this approximate average rate base, each multiple of $11,284 in operating profit would represent a 1% gross return.

Since the completion of the statements referred to herein, we have been advised by the Secretary of the company that computations just completed indicate a substantial increase in royalty payments to be made to the Provincial Government applicable to the year 1943. The recorded 1943 royalty costs applicable to gas wells represents 8.925% of production in comparison with a presently suggested percentage of 12½%; all results herein discussed are subject to this adjustment.

It will be noted that no attempt has been made herein to demonstrate the effect of price changes for crude oil or gasoline extraction. Whereas such changes

will naturally have an effect upon the operating results, it is suggested that only a very substantial change in the price of either crude or extraction would have a material effect upon the situation.

That as I said now applies to gas wells only.

The foregoing comments regarding the Royalite gas cap experience are not intended by us to convey the suggestion that cost of production, with or without provision for return on the investment, is the only, or for that matter, the best criterion of the value to be placed upon residue gas.

THE CHAIRMAN: Now are we to defer cross-examination on this phase of it and proceed?

MR. FENERTY: I can finish today. I am not prepared to have anything to say on this phase of it.

THE CHAIRMAN: And go back to what we were doing?

MR. FENERTY: Yes. That was the only additional part that was going to be put in today, was it?

MR. BLANCHARD: Yes.

.....

CONTINUED CROSS-EXAMINATION OF THE WITNESS BY MR. FENERTY.

Q Mr. Hamilton, I want to go back for a moment to that matter of Working Capital. I see that you estimate borrowing $50,000, if that should be necessary, would effect a saving, an annual saving of $7,900, that is computed on the basis of 15%.

A It is not precisely that, Mr. Fenerty. That is not the saving. You would have to deduct from that the amount that it did cost you to borrow the money from the bank.

Q Oh yes. Which would be perhaps 2, 3, 4, 5 or 6 per cent, whatever it might be?

A Correct. And for a shorter period of time.

Q Yes.

A You might borrow $50,000 at say 5% for two weeks and might never require it again until the next year.

Q This $7,900 was the straight computation on the basis of 15%.

A 15-5/6% on the basis of $50,000.

Q Let me get that. You compute say 5 or 6% on $50,000. That is the cost of borrowing the money. You have not computed that.

A No. I am not suggesting what it is going to cost if you borrow the money because I do not know what rate they will pay or how long they will borrow it for.

Q Then the saving would be the difference between . . . . .

A The $7,000-odd figure and whatever it does cost them or would cost them to actually borrow from the bank at a given rate of interest, a given sum for a given period.

Q It might be $2000 or $1500 or $3000, depending on the rate?

A And the amount and the duration of time for which the money was required.

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Q All right, but in any event on your Tables, the situation where the borrowing would be required, would not extend beyond two and a half or two and three-quarter months ?

A Under normal conditions, but there might be emergencies. I can imagine there being emergencies.

Q Yes, which would more than use up any surplus which had been piled up ?

A There could be.

Q I see.

A Those graphs, Mr. Fenerty, are predicated on normal operations and there might be unusual circumstances arise which would tend to disturb the graph line.

Q But for the expected normal year by year operation, you, on your Tables, there would be no occasion for any borrowing beyond two and a half or two and three-quarter months, between two and three months ?

A That is right.

Q Yes. Now dealing with the position of the stockholder as I understand it, the only place where the stockholder, the shareholder, is affected is that his equity, his equity in the assets of the company are affected to the extent that there is a debt owing to the Bank in priority to his claim on the assets, in the event of borrowing taking place ?

A That is right.

Q And I suggest to you that it is more or less academic rather than real, inasmuch as there is a definite source from which that money is to come to replace the borrowing, it is known, can be calculated and it is assured and that for all practical purposes that money is just as safe and can be counted on just as well as money actually in any funds of the Company ?

A You are suggesting now that the Royalite Oil Company can count, no, can be relied upon to furnish money to Madison ?

Q No, I am suggesting that the source from which the money will come to replace the money borrowed, you see on the basis of borrowing a hundred and forty thousand if you will ?

A Yes.

Q If you have a definite, fixed, ascertained source from which that money will come, that is the payments that Madison will receive month by month which will gradually wipe out, will repay the amount borrowed, will it not ?

A Yes.

Q And I say that is just as sure and just as certain as if it were cash in the Bank, that is what I am trying to say ?

A Oh no, I would not say that.

Q Is it not, under this system of regulation, with the prices fixed ?

A Oh no.

Q It has to come in if the operation is continued ?

A Yes, but no regulatory Board can guarantee that the operation will be successful. It can do its best to assure that it gets a reasonable rate.

Q But this amount which is fixed for the price of gas is going to come in each month ?

A Yes, they can provide that, but they cannot provide that people will buy the gas and that their operating expenses are what they are.

Q And if you know it is coming in each month and under a fixed price by the Board, you know that as long as gas is sold, that money is going to come in by instalments instead of having it in a lump sum in your hand ?

A That is right, so long as you know it is coming in.

Q And if you know that there is no practical possibility of loss to the shareholder as the result of borrowing against this money which is coming in three or four months as compared to expending your own money - -

A No, I do not think that is academic, Mr. Fenerty.

Q Then you have in mind at all times the system under which you are working, we are all working here, and the provision of the Act under which any formula may be adopted which shall appear just and reasonable, - now having in mind the fact that if an allowance is made for working capital based perhaps, - and an allowance for interest, - based on perhaps 9% plus income taxes for 15%, will result in an annual charge of $7,900.00, or over a period of two and a half, - yes, $7,900.00, that is fifty thousand, the equivalent of almost twenty thousand dollars, or a hundred and forty thousand worked out on the same basis - -

A Right.

Q And assuming money can be borrowed at maybe the going bank rate, there would be a very substantial saving of many thousands of dollars a year to the ultimate consumer, or in the first instance to the Canadian Western Company, would there not, by borrowing instead of an allowance for working capital, with a computation of 15%, there would be a very substantial saving, would there not ?

A Yes, it is bound to be cheaper if you are going to borrow money cheaper than the rate to be allowed by the Board.

Q Now I suggest to you, assuming again as a result of our discussion, where we have reached the conclusion that the shareholder has not been placed in any serious jeopardy - -

A You said it was merely academic, I did not say it was academic.

Q Have you not come to that place ?

A No, I think there is a very real point there which has to be appreciated.

Q Oh, you still do ?

A Yes.

Q You think there is a possibility that in the four months this account which we have calculated on, or counting on, will not come in, do you ?

A Well you see the borrowing is not done, you cannot rely on the borrowing being done only once.

Q You cannot rely on the borrowing being done what ?

A Only once. There will be a recurrence of this situation.

Q If you have some catastrophe ?

A Not necessarily.

Q If you have some catastrophe ?

A No, for any emergency which might creep up even of a minor nature, you may have to borrow and that is not restricted to the first four months of operation, it might occur again at the end of the second year and again at the end of the tenth year and again at the end of the twentieth year.

Q And if there is some emergency crops up, so that you have to look for the money somewhere ?

A Yes.

Q That might happen ?

A Yes.

Q But I am talking about, what you have allowed for, it excludes extraordinary emergencies, does it not ?

A No, depending upon the degree - -

Q Look, when you allow that one hundred and forty thousand

dollars working capital, you are not talking about any extraordinary emergency ?

A No.

Q And I am talking about the one hundred and forty thousand dollars working capital ?

A Right.

Q And to go back over it again, I am inviting you to assume that the company can borrow a hundred and forty thousand dollars at the going bank rate on the bases of your tables showing the income in the two and a half months will be sufficient to wipe that out and allow a surplus ?

A Right.

Q And I am assuming that you have no extraordinary emergency again, so that at the expiration of two and a half months you have wiped it out ?

A That is right.

Q And returned the money to the Bank ?

A That is right.

Q Now forget extraordinary emergency ?

A All right.

Q Take it on your chart and your reports and I suggest to you that it is now apparent that apart from there being any extraordinary emergency and the company borrowing a hundred and forty thousand dollars from the bank, a very substantial saving is effected as far as the Canadian Western in the first instance and the ultimate consumer in the second instance is concerned ?

A Yes.

Q And I suggest to you that that situation, with no extraordinary emergency again, that the shareholder is not prejudiced

in the slightest inasmuch as he has a definite return coming in which will wipe out his borrowing in two and a half months, which is just as safe as money in the bank, am I not right ?

A No, because - -

Q Without an emergency ?

A I will answer the question, you borrow the first month, I mean the first year and you pay that money back; at the end of the year the slate is clean, the dividends are paid out and you start over again and you borrow again.

Q Yes.

A The second year, and you must again come around and borrow the third year and the fourth year and the twentieth year and if for any reason this business should show signs of deterioration, there might come a time when the bank will say "We will not lend it to you".

Q I see. Then will you go this far with me, that for the first year and perhaps the second year and the third year, it would be proper to proceed by way of bank loans ?

A Right.

Q And there might for some reason, such as an improper rate being allowed to the company, there might come a tendency, say about the twelfth year, when bank loans would not be the proper procedure, or they could not get them ?

A No, my proposition was not that they should borrow a hundred and forty thousand dollars from the bank, that is your proposition and I did recognize that it would save money, but I say you must recognize if you require the company to borrow the money you are placing an added hazard on the shareholders, because he not only has to borrow now but he has to keep on borrowing from time to time for the duration of the enterprise and

there might come a time when he could not borrow money or if he borrowed the money it might put them into bankruptcy, or a number of such things might happen.

Q And you meet that by getting an adjustment of the rate base at that time ?

A And probably nobody would put in money.

Q I see, but I say you meet that ten or twelve years in the future if it ever happens, by discussing an allowance for capital, for working capital, or some other system than borrowing ?

A You could.

Q But for the present, here before this Board and so far as you can see for some time in the future, and assuming that proper allowance will be made by way of income taxes to all concerned, such as are reasonable and just, I suggest to you that applying the rules of, working out a formula that appears to be just and reasonable, with no immediate prospect of loss to the shareholders, with no immediate prospect of a heavy burden on the consumer which can be avoided, if this is a legitimate banking proposition, it would be just and reasonable for the present and so far as you can see for the next few years, to meet this situation by borrowing for that two and a half months, is that a fair proposition ?

A Well you use the expression "legitimate banking proposition", I do not believe it is a legitimate banking proposition to require the company to borrow for its original inventory. I say the company should be prepared to borrow for anything over and above normal requirements.

Q But it suggests itself to me, - the reason it suggested itself to me, why it was a fair banking proposition, was this chart of yours, WH-21, you have explained it to us and you showed where

the lines crossed, the red and the green and where it is built up and would you not say now that that very excellent chart is the best possible reason why this is a good banking proposition?

A I am not saying you could not borrow the money, but I am not saying that you should have to borrow the money. I quite agree with you if they did borrow the money the chances are the money would be paid back and the consumer would be saved money.

Q Now look, is it not a fair proposition to say to a Public Utility "You say we have uses for our own money, apparently we have ways we can invest this money so that we can get 15%', personally I do not see how they can invest money, income tax free but assuming they had some way of investing their money, income tax free, is it not good policy to say: "All right, you, by reason of being a public utility, under the circumstances of this case, you can get that money for the temporary period of two and a half months at three, four or five percent, - go ahead and use your money and invest it at 15%", that is what banks are for, to provide these temporary accommodations, when you have these situations, is that not fair and reasonable ?

A It is not a temporary situation, sir, it will occur every year.

Q A temporary situation for this year ?

A That is right.

Q You need the borrowing for this year, - never mind his line of credit for next year - -

A But I think he must look forward to his line of credit for next year because you have to have gas next year.

Q I suggest to you that an industry that is placed in this temporary situation, whether it is for ten years or two years, that the sound financing and the only financing that can

possibly be fair to the consumer, is that you cover your 2½ months by a bank loan in each year, do you not think that is fair?

A It would be very efficient and it would be very fair to the consumer. I am not sure it would be fair to the Company.

Q Now where does the Company lose anything, that is what I want to know?

A I do not think a Company should be placed in the position it has to borrow money for normal requirements.

Q Is this right, that if the Company does not lose anything and the consumer gains, that that is the only just and fair way of doing it.

A That is right.

Q Is that a sound proposition?

A That is sound.

Q And can you suggest any way that the Company can lose in the year it borrows that money and the shareholder is going to lose anything, bearing in mind they will not be able to borrow if the situation is not a sound one that year?

A That is just the point.

Q We have to say, where the situation is sound and justifies a bank loan.

A Right.

Q Then it is apparent to us the money will come back in 2½ months, now is there any possibility in that particular year of a shareholder losing anything?

A I will say "yes" on the basis of your assumption.

Q There is a possibility of him losing?

A No, I say the proposition is sound on the assumption you quote to me, that is you can get your money.

Q Then let us take just this year, in the first year, assuming they can borrow . . . . . .

A Right.

Q Then should that not be done?

A Not necessarily.

Q Well . . . . .

A Because . . . . . .

Q Well I cannot follow you there.

A Because the decision as to whether Working Capital is to be provided for this Company cannot be dealt with year by year. It has to be dealt with now with respect to the whole future of the Company's operations.

Q Oh, you are doing this on the basis that there never will be an adjustment of rate bases?

A No, but there has to be a proper plan provided at this time as to where they are to get their money.

Q You say that we have to have 15%. . . . .

A No.

Q Some rate which may be 15% or such rate as the Board may determine after a Hearing.

A Right.

Q But whatever that rate is, that that should be the charge now because something can happen in 10 years that you cannot tell me about, but there is that possibility which would render that factor unsound at that time, is that your theory?

A Well, Working Capital has to be provided now. When the time comes that you cannot borrow your money from the bank, where would you borrow it from? No investor would put it up at 15% or 20% then.

Q Will you go this far with me, that year by year, so long as

the position is sound enough to permit borrowing from the bank, that if the position is that sound, there can be no loss in that year to the shareholders.

A Right.

Q And if that is so for that year at least, and in any other year where that position still is in effect, in fairness, not merely to the Company but to the ultimate consumer, it should be accomplished by borrowing, leaving the Company to use its own money in any way it chooses, putting it in other investments if it likes, is that fair?

A No.

(Go to page 3923)

Q THE CHAIRMAN: Mr. Fenerty, are you suggesting that I have the power to order the Company to go and borrow money from the Bank ?

MR. FENERTY: What I suggest is you have a power to fix a rate which will adequately protect them if they use and employ reasonable principles of finance and it is up to them to see that they get protection.

Q Now this matter of historical cost, I want to come to that for a minute. In Exhibit 125 at the top of Page 3 or the bottom of Page 2,"turning now to historical cost we find two main issues arise:

1. The fact that historical costs does not embrace all the costs that could have been capitalized.
2. The fact that no part of the capital gain accruing from the advanced price levels accrues to the Company."

Now I want to consider those two objections. I want to take the second one first. The fact that no part of the capital gain accruing from advanced price levels accrues to the Company. I want to refer you to your evidence at Page 3753 in Volume 48. Near the centre of the page, Mr. Chambers' examination.

"Q MR. CHAMBERS: Mr. Hamilton, would you turn to Exhibit 125 please. Now on the second page you state as I understand it that the present prices are higher than the average for the construction period and that a valuation on the basis of present day prices would result in a capital gain accruing to Royalite. That is what in effect you say in the last to the second paragraph ?

A Yes sir.

Q And then you go on to say "that is the sort of gain which

in your view might reasonably be split between a willing buyer and a willing seller ?

A Yes sir."

Now I take it we are on common ground, in the suggestion that on the basis of reproduction cost with such depreciation as may be allowed on practically any system with the rising prices and greater price index now than before this necessarily results in a capital gain ?

A Right.

Q Now I want to refer you for a moment to the position taken by the Madison Company on this question of capital gain contained in a report submitted by the Madison Company by Mr. Barker. It is Exhibit 106, where my reading of the report is, he is giving reasons why there should be what I would call a high rate of interest allowed ?

MR. CHAMBERS: Is that the one Mr. Baker put in ?

MR. FENERTY: I beg your pardon, Mr. Baker.

Q He says in the first page of this report:

"I submit that a return of not less than 9½% is just and equitable, all circumstances considered.

<u>Circumstances</u>

(a) The investment is made and has to remain for the life of the project. The Company has nothing to gain by way of capital appreciation and only has a preferred position when considering capital protection with funds anchored to a single purpose."

Now I suggest to you that we have the submission filed by the Madison Company on the basis that they cannot in a proper computation here obtain a capital gain. That seems to be what they say, don't they. We have got the submission for a high

rate of interest because with a proper assessment of all the facts there will be no capital gain accrue to the company ?

A Oh the capital gain - if there was one would accrue to Royalite not to Madison. I think in fairness to Mr. Baker we must recognize that he is speaking of the Madison Company.

Q Oh yes. You say because the Royalite Company sells to the Madison ?

A In other words I think the difference is, in fairness to Mr. Baker, he is looking prospectively where you and I are now talking retrospectively and the point that Mr. Baker raises there has a bearing on the discussions which I had with Mr. Chambers this morning. I wish I had had that in front of me then.

Q You say on a basis of reproduction cost there would be a capital gain ?

A Yes.

Q To whom ?

A Royalite.

Q Oh, to Royalite ?

A Yes.

Q Because ?

A Because they spent some money twenty years ago and are getting paid more for it now than they spent twenty years ago.

Q Are you giving any consideration to what Madison paid for this property to Royalite ?

A Am I ?

Q Do you remember that Madison apparently paid for it in no par value shares ?

A Yes, no par value shares.

Q Without any price being fixed for the shares ?

A That is right.

Q And are you assuming that Madison has in fact paid the reproduction cost ?

A No, but I am saying that if this plant is given an established value for rate purposes of say $3,000,000.00 and if price levels remain the same for the next twenty-five years, and if the Madison Company recovers by way of depreciation the total amortization requisite then Madison has not made a capital gain but Royalite certainly has.

Q I see. Then your idea, I am trying to follow that, just why you say the Royalite has made a capital gain ?

A Well they may if your assumption -

Q Let me take this proposition and advance it to you. Royalite sells for no par shares ?

A Right.

Q And there is no cash value fixed ?

A Right.

Q I invite you to assume that as a result of that kind of a transaction the Madison Company has acquired this property on the basis of the book value of Royalite ?

A No.

Q You do not know. I do not know, nobody knows, do they ?

A You are asking me to assume that ?

Q I am asking you to assume that is so.

A Oh, yes, I do.

Q I have always said on this inquiry, and I have always suggested that it is improper to have shares of no par value. We have the situation here of no par value shares and I am asking you to assume that as a result of those no par value shares the Madison Company may be taken to have acquired those assets on the basis of replacement cost and I am suggesting to you for the purpose

of this discussion they were acquired on the basis of the book value to Royalite ?

A I will assume that.

Q Then I say in the event of the assets being valued to Madison on the basis of reproduction cost there is a capital gain to Madison, am I right ?

A There would be, yes.

Q And I suggest to you that the trend of this inquiry has been that Madison is taking the position that the valuation must be such that they will have no capital gain. Is that right ? In Mr. Baker's report, does that not follow, that is a reason for getting a high rate of return ?

A I do not know what rate of return they are getting.

Q We will leave that. That is the situation ?

A That is right.

Q It is an interesting one anyhow ?

A Yes a very interesting one.

Q And I take it that no one and you least of all would approve of a situation where a company goes to the Utility Board and says, I must have a high rate of interest because I cannot get a capital gain and then says, and I must have a certain system of valuation which will result in a capital gain. They should not have both should they ?

A No.

Q We will leave that. I want to turn again to Exhibit 125, to the objection No. 1. The fact that historical cost does not embrace all the costs that could have been capitalized ?

A Right.

Q And then I want to refer - that brings us now to the statement WH 6 in Volume 1. I want first to refer to those first four

columns. My understanding is that the suggestion is that this column 1, historical cost, does not include all of the actual costs which are found in the next three columns. The next three columns ?

A That is not precisely correct.

Q I want to get that now. Do they present the actual cost ?

A Not precisely correct. Columns 2, 3 and 4 represent an adjustment in respect to those elements of cost. I am not suggesting that they are the precise amounts.

Q I see.

A Obviously they cannot be because the overhead is a percentage. I am not suggesting that perhaps the percentage might not be out.

Q And as a matter of fact those are not all. They are not actual costs or all of them are not actual costs in the sense that they are money that you paid out are they ?

A They are intended to be.

Q All of them. I mean your general overhead.

A Yes.

Q But all those items are money paid out ?

A I would not include it if it were not actual cost. That is at least my intention.

Q Did you satisfy yourself when you included those items in those three columns that none of them were duplicated in any way in the historical cost ?

A I satisfied myself generally that the items contained in these classifications, glycol and M.E.A. transportation and construction equipment charges and general overhead are not included in the historical cost except in one or two minor instances and to a minor degree.

Q I see.

A But substantially speaking those elements of cost are not included in historical cost.

Q Is it true that all these costs in the second, third and fourth columnsare included in the books of the company as charges against income ?

A Not necessarily these precise amounts, but the cost of things of this type are carried up against the operations of the company from year to year.

Q You do not know whether that would be in a greater or lesser amount ?

A No I do not know. It is impossible of determination.

Q You have ascertained that those classifications, the company has to charge those classifications against income ?

A Yes, that is right.

Q Whether these are just the total, these amounts, you just do not know ?

A That is right.

( Go to Page 3930 )

Q And if the company has followed its practice in the past, these amounts would have been charged against income?

A That is right.

Q I see. All right, now I think you have told us and we all seem to agree, that both the Royalite and Madison Companies have had competent bookkeeping set-ups?

A Yes.

Q And expert accountants?

A Yes.

Q Handling their affairs?

A Yes.

Q And I think perhaps you would go so far as to say that the Income Tax Department of the Dominion Government also has some competent accountants in their service?

A Yes.

Q That is without prejudice you know to anything in the future?

A Yes.

THE CHAIRMAN: And one at least that I know of?

Q MR. FENERTY: I am going to suggest to you, Mr. Hamilton, that the principles governing capital income and the charges to capital and income are of general application?

A Yes.

Q There is not in any Income Tax or other statute that you know of any statutory provision whereby certain things are charged to income and certain things are charged to capital?

A There are casual references I suppose in various statutes, but there is no place that I know where you can find an enunciated principle laid down by law as to what is capital and what is income.

Q And you are aware, of course, of provisions in some of our

Acts whereby dividends are paid out of profits, leaving out cases of wasting of assets.

A Yes.

Q Whereby dividends are required to be paid out of profits?

A Yes.

(Go to page 3932 ).

Q I suggest to you that while there might be some difficulty in their application there are principles which govern the determination of profits for all circumstances. Will you go that far?

A You mean that the same principles apply for everything?

Q I say a thing is either a profit or it is not a profit in any company. Will you go that far then?

A Yes.

Q And it follows that the thing is either a capital gain, money received after allowing for operating expenses and so on, surplus, is either a capital gain or a profit isn't it, or income?

A Yes. But there are no two people will agree.

Q I suggest to you that in income tax practice there is no difference between what is properly chargeable to income and what is properly chargeable to capital than in any other situation. Will you go that far? In other words, it is either properly chargeable to income or it is not?

A That is right.

Q No matter what you have in mind?

A That is right.

Q And if it is properly chargeable to income, it is improperly chargeable to capital, that follows.

A For the same purpose.

Q For every purpose?

A Oh no.

Q No?

A No.

Q Well I suggest to you that that is so?

A I disagree.

Q You think there may be a special proper way of dealing with it for income tax purposes as distinguished from other purposes?

A Yes.

Q Just where do you get that from?

A Pardon?

Q Just where do you get that from?

A Oh, special provisions such as writing off of exploration costs against income.

Q You are not talking about what they got away with, you are talking about what they should do?

A I am talking about what they do.

Q I am going to suggest to you, and invite you to criticize, that if an item is properly a charge against income or properly a charge against capital, you see?

A Yes.

Q It is necessarily so no matter what object you seek to accomplish, would you say that?

A I do not agree with you.

Q What?

A I do not agree with you.

Q I see. You think that your object determines whether the thing is chargeable against capital or income?

A No, I do not say it determines it, but I say the purpose you have in mind has some effect to the classification of items.

Q I see.

A You classify them for what reason?

Q I see. All right, we will leave it at that. Now, I gather from what I have heard before that you are fully familiar with the provision of Section 6(b), dealing with deductions from income not allowed, which says that amongst those not

alowed , "In computing the amount of the profit or gains to be assessed, a deduction shall not be allowed in respect of,"

as in Subsection (b), "Any outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence, except as otherwise provided by the Act?"

A That is right.

Q And if a deduction or if an expense which is properly chargeable to capital has been charged to income, that necessarily results in an apparent decrease in income, doesn't it?

A Right.

Q Or profit rather, decrease in profit, not income?

A Right.

Q A net income?

A Yes.

Q Yes. And the result is that if that continues to stand, the taxpayer has obtained a deduction which he was not entitled to under the Act?

A He is getting a deduction that he would not otherwise have got.

Q Something that should have been properly charged to capital, you see, has been charged to income, and it is allowed to stand, I say if that is so, and it is allowed to stand, he has obtained a benefit at the expense of the Dominion Government which he would not have obtained had it been charged to capital?

A That is right.

Q That is right?

A Yes. The word "improperly" was not in your last question was it?

Q What is that?

A The word "improperly" was not in your last question to which I said "Yes"?

Q I see. But with that in the answer is "That is right"?

A The answer is "No" if you put in the word "improperly".

Q I am not trying to make it any too complicated. All I am saying now is, I want you to assume for a moment that a certain expense was undoubtedly a capital expense, and should have been charged to capital?

A Right.

Q I want you to assume that perhaps through an error, we will say, that was charged to income?

A Right.

Q And that charge to income was not disallowed by the taxing authorities?

A Right.

Q I say, the result is, the result of that error and that failure to disallow it, that the taxpayer has obtained a benefit at the expense of the Dominion taxing authorities?

A Right.

Q That is so?

A Right.

MR. CHAMBERS: If the Board please, if you don't mind I would like to interject for a minute. I do suggest that there are certain things which the Board should deal with here to day specifically, and one thing I have in mind is Mr. Steer's Agreement as to Contents of the appeal book, and I think that he wants it decided today. I am suggesting that we might spend the next fifteen minutes dealing with those things.

MR. FENERTY: If I might continue until a quarter

to one, will that be all right?

THE CHAIRMAN: Yes.

MR. FENERTY: I think I can finish this particular part.

Q Now you have told us that items in the similar category to those referred to in Columns 2, 3 and 4, the Statement WH-6, were charged by the Royalite Company to income?

A Right.

Q And you do not know whether theyamount to more or less than that?

A That is right.

Q And if they had followed the same practice those items will have been charged to income?

A That is right.

Q And so far as you know that system of those charges has not been disapproved of by the Income Tax Department?

A I do not know anything about the Income Tax.

Q I did not know whether an examination of the books showed that with regard to the income tax?

A Not at all.

Q And you do not know whether those were questioned by the Income Tax authorities?

A I do not know anything about it.

Q You do not know?

A No, I do not know.

Q You do not know of any disallowance or you do not know of any appeal?

A No, that is right.

Q And so far as the books of the Royalite Company are concerned, they are today, as far as you know, making this kind of charge and taking the benefit of it?

A I know that they have those accounts in their books. How they draw their tax accounts I do not know. They might have charged them back.

Q Maybe they will tell us that. But so far as you know, they are taking the benefit for income tax purposes of those charges?

A I do not know that.

Q You do not know?

A No., I do not know how they prepare the income tax.

Q I did not know how far you had investigated, Mr. Hamilton?

A I do not know that. I might say that I assume that they take advantage of those charges for tax purposes. I will assume that.

Q Yes, I think perhaps you can fairly do so. Now, I want to find the reference I had in mind and I seem to have mislaid it somewhere. There was a question put to you by Mr. Chambers. Will you pardon me just a moment? I am sorry to take this time. Do you remember in answer to Mr. Chambers, agreeing with Mr. Chambers, that the deductions and exemptions which the Income Tax authorities allow under their regulations in the Act, that what they allow was a reasonable test of their fairness with regard to those particular deductions and exemptions?

A What type of deductions?

Q Do you remember agreeing with Mr. Chambers that the deductions and exemptions allowed by the Income Tax authorities were fair?

A Oh, I would say they were more than fair. They are liberal. That is, if you are speaking of depreciation.

Q Yes?

A I will have to qualify that too. In some cases they are very

liberal, and in some cases they are rather niggardly.

Q I unfortunately put away all my stuff when I thought we were not going to go on with the examination, and that is one reason why I was fumbling around a bit. I want to refer you to page 3691 of Volume 47. Here it is.

"Q In other words I take it from your Exhibit 125 you in effect say that the book depreciation is not the proper amount that should be taken by the Board in fixing the present day depreciation for rate base purpose. Is that a fair way to put it?

A For this company, yes sir.

Q Now Royalite did actually put its depreciation at 10%"

MR. CHAMBERS: That word "put" should be "book" obviously.

MR. FENERTY: "Book"?

MR. CHAMBERS: Yes.

MR. FENERTY:

"A I think the uniform rate".....

No, that isn't it. It is almost a quarter to. If I can stop now, I will get this reference.

THE CHAIRMAN: All right. Well, shall we adjourn to the 12th?

MR. McDONALD: There will be no necessary of opening tomorrow just to qualify the next witness?

THE CHAIRMAN: It will only take a few minutes on the 12th.

MR. McDONALD: Yes.

THE CHAIRMAN: Then we can go right ahead. Mr.

Hamilton would like to get away.

MR. McDONALD Yes, and I understand Mr.Steer would like to get away to Edmonton too.

THE CHAIRMAN: We will adjourn to the 12th.

(The Hearing was then adjourned to November 12th, 1945, at 9.30 A.M.)

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